No. 9901

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

FONTANA POWER COMPANY, a corporation,

Petitioner and Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent and Appellee.

APPELLANT'S REPLY BRIEF.

GEO. W. HELLYER,
JOHN B. SURR,
204 Citizens National Bank Building,
San Bernardino, California,
Counsel for Appellant.

Parker & Baird Company, Law Printers, Los Angeles.

TABLE OF AUTHORITIES CITED.

Cases.

No. 9901

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

FONTANA POWER COMPANY, a corporation,

Petitioner and Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent and Appellee.

APPELLANT'S CLOSING BRIEF.

Unless otherwise noted, all emphasis herein has been added by appellant.

In appellant's opening brief (pp. 12, 13, 14), it was emphasized that the agreement under which the payments were made *did not* provide for payment of *all* of appellant's profits. Under such agreement there was to be deducted or taken from "profits", "operating expenses (including depreciation), taxes, interest, all obligations which it (appellant) may incur or for which it may become responsible, and dividends of not exceeding eight per cent (8%) per annum, upon its outstanding capital stock" [Tr. 34].

The agreement clearly defined the amount to be paid, but such amount was not "profits" within the lexicon of investors, lawyers and tax authorities.

In appellant's opening brief (p. 14) it was also emphasized that the payments were not the same as net income, for, after making and deducting them, appellant had for the three years involved, a net income of $23,965.08, or an average annual net income of $7,985.03, on which appellant paid income taxes.

There is no dispute respecting the foregoing statements. But it must be that respondent did not read appellant's brief or that respondent did not note or understand the correct facts involved, for at no place in respondent's brief are the true facts in this particular stated. On the contrary, every reference to such matters in respondent's brief is inexact and incorrect, and anyone reading respondent's brief would be left with an erroneous conception upon this phase.

Such erroneous statements commence on page 1, where, in stating the question, respondent refers to the payments as "amounting to all profits, after operating expenses, taxes and an eight per cent dividend".

The next reference is in the statement of facts, where on page 5 respondent erroneously declares the agreement required appellant to pay the vendors "all its earnings after providing for the payment of operating expenses, taxes and interest on all obligations which it might incur". (Perhaps this erroneous statement, apart from omission of dividends, is attributable to a typographical error! The agreement provided for deductions of ". . . taxes, interest, all obligations which it may incur or for which it may become responsible and . . .". Respondent changes this to "taxes and interest *on* all obligations which it might incur".)

The other references in respondent's brief to the terms of the agreement under consideration, and the payments, are as follows:

(No. 3) "taxpayer . . . pending the determination of that difference, agreed to pay to the vendors *all its profits*. For twenty years thereafter the taxpayer distributed its *profits* pursuant to the agreement" (p. 9).

(No. 4) "In providing for payment to the stockholders of *all of the profits over operating expenses, taxes, and an agreed eight per cent dividend*, the vendors were merely taking what they were entitled to as stockholders" (p. 11).

(No. 5) "Until an agreed valuation could be made, the vendors received *all of the profits*" (p. 12).

(No. 6) "They (vendors) received *all the net income* from the property" (p. 12).

(No. 7) ". . . the payment of *all net profits* as so-called 'interest' absorbed all the taxpayer's resources . . ." (p. 13).

(No. 8) "Here the substance was the payment to the sole stockholder of *all profits as such*" (p. 15).

The agreement provided a yardstick for determining the amount to be paid. But this yardstick was not *"all profits"* as respondent so persistently states. Respondent's erroneous statements recurring like the theme-song in Snow White, are well calculated to linger in mind.

The agreement provided for payment of the difference between the value of the properties conveyed to appellant and the 100 shares of stock issued as part payment. This difference may properly be referred to

as the balance of the purchase price. Such balance was payable when the value of the properties and the method of payment was agreed upon by the parties and approved by the Railroad Commission. On page 10 of his brief, respondent refers to this balance as "mythical" and writes "no attempt has ever been made to determine this mythical difference [R. 13] and nothing has ever been paid on the 'balance' of the purchase price". If respondent's statement had been confined to the time of hearing before the Tax Board, the statement would have been correct had the word "mythical" been omitted, but the statement is not restricted and speaks in the present tense. In this the statement is not correct. Subsequent to the hearing before the Tax Board, appellant and Water Company agreed that this balance or difference was the sum of $340,000 and the Railroad Commission, after a public hearing, has under consideration appellant's application for leave to pay that amount.

In his brief, respondent does not appear to have followed the theory underlying the Board's opinion. The Board recognized that the payments were made under and pursuant to the agreement and that the holding of 100 shares of appellant's stock was extraneous. At the utmost, the Board looked upon such shareholding as throwing some light upon "the real intent of the parties", which the Board states "is to be ferreted out" [Tr. 16].

Respondent's theory appears to be that the payments were attributable to the holding of 100 shares of stock and the payments were made to Water Company as the holder of 100 shares of stock and, hence, were dividends on the 100 shares. That was the theory for which respondent contended before the Board. The Board did not

follow it. It was this situation that caused appellant to write at page 17 of appellant's opening brief:

> "The Board appears to have decided the case on the theory that the relation of Water Company to appellant was that of shareholder and not creditor. Hence, the payments were in the nature of dividends. The Board says, 'In a majority of the cases of this nature which have come before this Board, the instrument issued by the corporation has been some form of stock certificate' [Tr. 15]. *Nowhere in the extensive briefs filed with the Board was there any express discussion of such theory.*"

The Board further said [Tr. 15] "in each proceeding of this nature it must be determined on the facts presented whether the real transaction was that of an investment in the corporation or a loan to it. (Case cited.) On this question the designation of the *instrument* and the terms therein incorporated, while not to be ignored, are not conclusive". After some discussion of the facts, the Board concluded "The transaction was strictly an investment from 1916 up to and including the taxable years. . . It may be true that the agreement of 1916 indicated a possibility of the creation of a debtor-creditor relationship and the method to be followed if such a relationship were to be created in the future, but the mere existence of this possibility, which was never fulfilled, cannot affect our conclusion that, in reality, during the years in question the relationship of the Water Co. to petitioner was that of an investor and not that of a creditor".

Respondent writes (p. 11), "In providing for payment to the stockholders of all of the profits . . .

the vendors were merely taking what they were entitled to as stockholders" and (p. 13) "The Water Company was a stockholder because it held the stock. No one contends that the agreement made it a stockholder".

The agreement did not provide for payment to the stockholders as such of any amount. It provided for payment to those who at the time were also shareholders. The obligation would have continued whether the payees retained the shares or not. The payments were made pursuant to the agreement and not pursuant to any rights of Water Company and Fontana Company as holders of shares.

Respondent's statement that the vendors took "what they were entitled to as stockholders" is clearly wrong. They took 8% dividends as stockholders and they took the payments under the agreement as obligees or payees under the agreement.

Suppose a person conveyed property to a corporation in exchange for all of its shares and its bonds in the amount of $100,000. Interest paid on the bonds to the bondholder (who also happened to be the sole shareholder) would not constitute a "distribution made by a corporation to its shareholders" so as to be a dividend within the income tax law. Nor would it make the payments dividends because the property had been conveyed and the stock and bonds issued as part of the same transaction. Nor would the interest payments have become dividends because the stockholder controlled the corporation, or was "friendly" to it, or the transaction was not made at arms length. For reasons that seemed sufficient to the incorporator, he might have caused the corporation to provide either a low or a

high interest rate. The possibility that the corporation's earnings might not be sufficient to pay the bond interest would not have made the holder of the bonds an "investor", *i. e.*, a shareholder as opposed to a creditor.

None of such matters in the supposititious case would have altered the basic fact that the bonds evidenced a debt and payments on them were made because of the debtor-creditor relation, and not because the holder of the bonds also held the corporation's shares.

Generally those forming a corporation are friendly to it, and it is responsive to their desires and gives effect to their plans within the law. This is probably more true in the case of the private corporation than in the case of a public utility in California, where, under the law, stocks, bonds and notes of a public utility can be issued only for certain considerations with the approval of the Railroad Commission.

Suppose in the instant case, Water Company disposed of the 100 shares to which respondent attaches such significance. Would not appellant be required to make the same payments that it had theretofore made. Clearly it would. Then it follows that the payments are made because of the agreement and not because of the holding of 100 shares of stock. If the shares were disposed of, then the question would be whether the payments were made to Water Company because of a shareholder or a debtor-creditor relation. But that relation arises under the agreement and the final question is whether the agreement either alone, or taken in connection with all the circumstances, creates a debtor-creditor relation or a shareholder relationship.

Respondent's theory that the payments were attributable to the holding of 100 shares is unsound. The Board's theory is the only possible theory on which it might be held that the payments were dividends. But that theory finally runs against the barrier of the law. The Board's theory means that the agreement construed with attending circumstances, but without regard to who holds the 100 shares, creates a shareholder relationship. As pointed out in appellant's opening brief, that result was legally impossible.

The Railroad Commission could not have authorized a shareholding relation with rights like those of Water Company under the agreement. But the Commission could authorize a debtor-creditor relation with those rights. No one has questioned nor can successfully question the validity of the agreement. If it be valid (and it must be), then it creates a debtor-creditor relation.

It would, indeed, be interesting to note the argument of respondent in a subsequent action involving this agreement if the one receiving the payments were not also a shareholder.

Respondent writes (p. 10): "The vendors conveyed the property to taxpayer and became the sole stockholders. The stock represented, therefore, the full value of the property conveyed". If one conveyed property solely in exchange for stock, the stock would represent the full value of the property, but if one conveyed property in exchange for stock and an obligation to pay (say $340,000), the stock would not represent the full value of the property. In the instant case, the application of appellant to the Commission, the decision of the

Commission and the agreement of the parties specified that the 100 shares of par value of $10,000 were to be issued as part payment. Respondent seeks to make a new agreement for the parties and, where they and the Commission had agreed and provided that the 100 shares were part payment, he would cause them to be full payment.

Both the Constitution and the Civil Code of California prohibited issuance of stock except for money paid, labor done or property received. If shares of the par value of $10,000 had been issue for $1,000, they would not have been fully paid and the holder could have been compelled to pay the difference between the par value and the amount actually paid. Property or cash corresponding to the par value had to be received and the whole theory underlying capital stock and shares was that the consideration received was equivalent to the par value of the shares. It is presumed that the value of a share is its par value. Especially do these principles apply to public utilities where the capital stock is important for rate making. It is clear that the parties to the agreement gave to the stock issued a value corresponding to the par value.

Respondent further writes (p. 10) "no reason appears why the properties could not have been conveyed solely for stock". That statement is not correct. A reason does appear why the properties could not have been conveyed solely for stock. The value of the properties had not been determined when the agreement was made. Until that determination was made, the amount of stock that might legally be issued could not be known. There must have been evidence before the Commission that such

value exceeded $10,000 or it would not have made order 3773, reading [Tr. 30]:

> "It is hereby ordered that Fontana Power Company be granted authority, and it is hereby granted authority, to issue one hundred (100) shares of its capital stock of the par value of One Hundred Dollars ($100) per share to Fontana Union Water Company and Fontana Company *as part payment* for the power house site, rights of way and rights to use certain waters of Lytle Creek, in San Bernardino County."

At pages 8 and 9 of his brief respondent cites cases in which payments were held to be distributions in the nature of dividends, although they were labeled or appeared to be something else. An equal number might be cited in which payments were held to be interest, although called dividends, or something else.

An examination of the cases referred to by respondent will show that where there was an agreement providing for payments, that agreement was considered and construed, and if it was found to create a stockholders' interest, then the distributions were held to be dividends. But respondent does not do that. Respondent, in effect, ignores the agreement in the present case and argues the payments were attributable to the holding of 100 shares, and not to the agreement.

There is no claim of tax evasion in the present case and the case should not be confused with those cases where payments were made to a stockholder under an agreement, as for salary or rent, and it is found that the payments were not *bona fide,* that is, they were not actually attributable to the debtor-creditor relation, but

were, in fact, induced by and attributable to a stockholder relation.

In any event, the agreement in the instant case was *bona fide* and it should be held by its four corners to determine the relation of the payee or payees and the payor.

Suppose a contract of a corporation disclosed an indebtedness and an agreement to pay a certain amount as interest. In case of dispute over the deductibility of the amount paid as interest, when it was admitted or established that the payment had been made pursuant to the contract, then, *prima facie*, its deductibility as interest was established. The contract would show its purpose, and would show it was paid as interest on indebtedness. To defeat deductibility in such assumed case, it would be necessary for the Commissioner to allege and prove the contract was motivated by an attempt to evade taxes and was fraudulent as to the Treasury. *Commissioner v. Van Vorst* (C. C. A. 9, 1932), 52 F. (2d) 677.

In the *Van Vorst* case, *supra*, it appeared a controlling shareholder purchased for $54,599.60 a property that was stipulated to be worth $100,000 more. The corporation had surplus profits of more than $300,000, and the Commissioner contended that the value of the property over the amount paid was a distribution and that the stockholder realized income in the amount of $100,000. Said the Court:

> "There is no recital of any fact in the stipulation that is remotely suggestive of fraud or ulterior motive nor is it so contended. Counsel for petitioner, however, contend that 'the gross inadequacy of the

> consideration and the relationship of the decedent to the corporation clearly support the commissioner's determination and demonstrate that what was called a sale was in reality a distribution of assets'. If this contention is to be sustained, it must be based upon the proposition urged that, because the consideration was so inadequate and the purchaser was the principal stockholder, it should for these reasons alone be regarded as a taxable distribution. . . . In the absence of other showing the mere fact that the purchaser is a stockholder of the vending corporation does not change the character of the transaction."

In the *Van Vorst* case, the court referred to *Taplin v. Commissioner,* 41 F. (2d) 454 where a sale of stock to stockholding officers for less than 25% of its value was held not to result in income, and where the court had said respecting the Commissioner's claims:

> "This is equivalent to a charge of fraud against the government and fraud is never presumed. It must be proven by clear and convincing evidence."

Respondent states the payments were not denominated "interest". True, but that is unimportant. Respondent refers to interest as compensation paid for the use of borrowed money and says no money was loaned. But interest is also paid and allowed as a deduction for income tax purposes on the numerous contracts for the sale of real and personal property.

The payments in question were made pursuant to the agreement. Such has been stipulated by counsel and necessarily found by the Board [Tr. 12]. Even respondent has written (p. 9), "The distributions in this case were made pursuant to an agreement whereby the taxpayer acquired certain properties".

That agreement created a debtor-creditor relation whereby appellant became bound to pay the balance of the reasonable value of the property appellant received. The payments in question are in the nature of compensation for delay in payment of such balance and are, therefore, interest.

Respectfully submitted,

Geo. W. Hellyer,
John B. Surr,
Counsel for Appellant.